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INVESTMENT MANAGEMENT
Money Managers You Can Trust

January 2019 Thoughts and Insights

We'd like to start this letter by wishing you and your families a healthy, joyful, and prosperous 2019!

Throughout 2018, our market outlook was focused on the late stage of the economic and business cycle and the 10-year bull market possibly coming to an end. Early in the year we took profits by bringing our equity exposures back into their normal ranges. Late in the summer, we became more defensive in our stock allocations by reducing our exposure to financials, energy, and industrials, and increasing our exposure to healthcare, consumer staples and real estate.

For many years our approach to investment research was primarily focused on the main fundamentals in the economy: growth, inflation, employment, interest rates, and corporate profits. These factors are the foundation for how to project what the intrinsic value of a company should be. From there, we decide which companies are poised to grow given the current conditions. This is what is called Fundamental Analysis. Another investment approach is Technical Analysis which looks at price movement, volume, and volatility giving us insight into market participant's behavior and sentiment. Technical Analysis is most helpful in timing trades and indicating sentiment changes in the market. Over the past few years, the market has become increasingly more dominated by algorithmic trades based on computer and math models, and not on fundamentals. As such, we have incorporated Technical Analysis into our investment decisions.

On October 10th, the market's volatility surged to more than eight times that of its average volatility over the previous 20 days. This is a technical sign that has been seen only six other times, all of which have preceded previous bear markets. Per technical experts, sometimes it takes up to a year for the real stress to emerge and we may see multiple quarters where stocks are sideways or even hit highs before ultimately turning down. This indicator signals stress simmering below the surface of the market. It shows that market participants are beginning to behave differently, generally getting more cautious, more risk averse, and more sensitive to negative news items and data.

In response to this indicator, in late October we reduced our equity exposure by 15% and purchased money market funds that pay +2% with the cash. In December, we added utilities stocks that are historically defensive. Finally, given the increased volatility over the holidays, we took advantage of a very strong day last week to sell more of our indexed ETFs.

Despite the recent market losses, the current economic data is strong. This is not surprising as the stock market is the leading indicator of current stresses in the business cycle and broad economy.

- Third quarter GDP grew at 3.36%; solid, but slightly less than second quarter and fourth quarter is expected to decelerate further.
- Consumer spending is robust.
- Auto sales are stable however, the housing market is starting to show weakness.
- Unemployment is at historical lows.
- Durable goods orders peaked in the second quarter of the year and are beginning to slow and show signs of weakness.
- The impact of trade and tariff policy is complex and, frankly, is impossible to fully understand until history plays out. It is clear to say that trade is front and center in the

President's mind, and that trade wars (or threats of) have had an impact on policy worldwide, especially in China. The ongoing trade saga is also weighing heavily on business investment decisions and will likely have a material impact on capital expenditures until there is a resolution.

With respect to the fixed income markets, the Fed raised rates four times in 2018. Many of the data points that the Fed uses show they have achieved target inflation with relatively full employment, thus reducing market expectations for further rate hikes in 2019. The yield curve has flattened, but the most important indicator of an impending recession is the spread between the 2- and 10-year treasuries which has yet to invert. This spread is important because banks generally borrow based on the 2-year rate and lend based on the 10-year rate. So, when the 10-year yield is less than 2-year yield, banks are not able to be fully compensated for the risk causing them to pull back on lending. When rates rise bond prices fall, so we anticipated some price declines in our fixed income holdings. We were prepared for this as our focus has been on coupon payments and short maturities to buffer these price declines.

In conclusion, despite the strong economic data and recent bounce in equity markets, there are definite signs that the current bull market is in a topping pattern, so we are cautious and prepared for increasing market volatility and possibly even a bear market in the coming year. We plan to use some of the equity dollars for a long/short fund that will take advantage of declining stocks, and in fixed income we plan to reduce some of our credit (riskier) exposure.

Our goal at DTIM is never to outperform rising markets but to protect losses on the downside and preserve principal. We know sticking to long term allocations generates the best investment outcomes over the long run.

As always, we remain dedicated to serving your investment needs according to your goals. Please call or write with any questions you may have or join us in the lounge with the beverage of your choice for enlightening discussions.

Michelle & Kyle